

[The following article, written by John Sfakianakis, Chief Economist of SABB was published in the FT on September 17 2008. John will be the main speaker at the December Special Briefing]

Turmoil demonstrates link with world



What is happening in the global financial system cannot but affect the states of the Gulf Co-operation Council in spite of their macroeconomic soundness. The notion that the region had decoupled from the world economy is proving to be incorrect.

Of course, the effects depend on the duration and magnitude of the global economic turmoil. We are not yet at the point of a global economic cataclysm, but we can discern effects in the Gulf.

The region has attracted substantial overseas investment, and this inflow of capital will dwindle if the world slows down. There will be less investor appetite and fewer tourists. Some Gulf states - notably Dubai - have made energetic, possibly overly exuberant, attempts to "sell" themselves to the world, and that makes the region intertwined with global economic trends.

Saudi Arabia has presented a more conservative, less "sellable" image and this seems to have given it a cushion. The kingdom is not dependent on foreign property buyers, tourists or hub travellers.

The unwinding of the commodities super-cycle has affected oil prices. Although GCC states are fiscally comfortable, with oil prices between \$80 and \$100 a barrel, they are not immune to the dynamics of global demand destruction. Saudi Arabia's daily oil export revenue has fallen to little more than \$500m from a high of \$1.05bn. Even if oil prices fall to \$60 a barrel, the revenue base of the GCC states will be secure because most have adhered to fiscal discipline.

Only a year ago many international fund managers were finding it hard to understand why Saudi Arabia should base its budget on an oil price of \$50 per barrel. Only if oil prices enter a paradigm of, say, \$50-\$60 a barrel over the long term will the GCC states have to make serious planning adjustments. So far the appreciation of the dollar has offered an ample counterbalance to maintain purchasing power.

But here is the bad news. The region faces its own credit crunch because of banks' balance sheet limitations. Demand for credit facilities is much higher than supply of credit in an environment where most Gulf states face negative real interest rates. Banks want to attract deposits but that is difficult when central banks are trying to mop up liquidity by issuing bonds to push inflation down.

In the case of Saudi Arabia, government T-bills issuance has risen more than 340 per cent since

December 2007. An estimated \$45bn in speculative funds, which quit the region after the end of the revaluation debate, have not helped banks' deposits base. The cost of funding in the region is rising fast and there is no end in sight.

This has two likely consequences. First, private sector credit growth will slow and profit margins will be squeezed. Many companies will find it hard to pass higher costs on to consumers. Second, more positively, slower credit growth could ease inflationary pressures. Importantly, a stronger dollar is helping all the GCC countries become importers of deflation.

The region's stock markets have been affected by the global turmoil. Foreign funds have been exiting since the beginning of summer, mainly in the UAE and Qatar, pushed by governance issues in Dubai and a decline in oil prices since mid-July. Selling Gulf equities may appear logical when the oil price is declining but the correlation between oil and regional stock markets is flat if not negative.

If global sentiment worsens and markets have more sellers than buyers, regional markets will continue to be anaemic in spite of attractive pricing.

Elsewhere, the equities and real estate slump in the US and Europe is affecting sovereign and individual net wealth. Although Gulf SWFs are inclined, for political reasons, to absorb these losses with little complaint, individuals' net worth positions will be affected.

Global shakedown has one other important impact. The market is beginning to categorise projects and countries according to risk-premium factors. Regional credit markets, mainly Dubai, Abu Dhabi and Qatar, are affected by negative sentiment - and there is particularly concern over Dubai. Although the market may be mispricing risk, perception can lead to reality. Saudi Arabia, which has not entered the credit market as aggressively, remains healthy and risk averse.